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SUBJECT: NEW ZEALAND'S 2007 BUDGET NOT LIKELY TO PRODUCE
POLITICAL DIVIDENDS

REF: WELLINGTON 351

1) (U) SUMMARY: New Zealand's political punditry has given Labour's 2007 Budget a tepid response. While many wage earners may decide the Budget's centerpiece, a national pension saving scheme - KiwiSaver, could provide them some benefit, the majority of voters will likely be indifferent or resent another year of no relief in their personal tax rates. New Zealand faces major economic challenges, including an overvalued exchange rate that hinders imports, high interest rates that inhibit investments, and a ballooning trade deficit (reftel). The Government argues that tax cuts would exacerbate these problems, but its new budget is unlikely to reverse these trends. Nor will it reverse the Government's sliding poll ratings, as New Zealanders are likely to question why Labour has once again failed to provide them with any immediate material benefits despite the Government's huge operating surplus. End summary.

Budget Basics

12. (U) On May 17th New Zealand's Minister of Finance, Dr. Michael Cullen released the Labour Government's 2007 Budget, which he promised will address both short-term economic imbalances (current account deficit, higher inflation and high exchange rate) along with medium-term challenges (improve low household savings rates and stimulate investment). The Budget's two main initiatives are the "KiwiSaver" superannuation (pension) top up plan and a set of cautious reductions in business taxes. KiwiSaver (first proposed in 2005) is a scheme designed to help improve household savings and to provide New Zealanders with additional retirement funds supplementing the current national superannuation fund.

13. (U) With the 2007 Budget, KiwiSaver now becomes a reality when the next fiscal year starts on July 1. As an incentive to encourage broad participation in the scheme, the government will kick start each new member's account with a NZ\$1,000 (USD \$730) contribution and provide a tax credit of up to NZ\$20 per week (about NZ\$1040 per year per individual). In an unexpected wrinkle, from 1 April 2008 employers of all KiwiSaver participants will be required to contribute to the accounts. The compulsory employer contributions will start at 1% of participating employees' salaries and increase by 1% each year until 2012, when the compulsory employer

contribution will reach 4%. Employers will receive up to NZ\$20 per week per employee in tax credits for their contributions. GNZ estimates that the cost in deferred Government revenue will be approximately NZ\$3 billion over four years, with NZ\$1.6 billion going to employees as tax credits and NZ\$1.4 billion in tax credits for employers. Goldman Sachs further estimates KiwiSaver will generate increased overall savings of between NZ\$5 and NZ\$7 billion a year by 2013. The hope is that with this large pool of domestic capital, New Zealand's reliance on foreign capital and the overall cost of capital will be reduced, giving New Zealand investors a greater ownership stake in the economy.

¶4. (U) The second important aspect of the Budget is a change to business taxes, the most important feature being the reduction in the corporate tax rate from 33% to 30%. This will partly offset the cost of KiwiSaver to employers. It will in addition set the NZ corporate tax rate at the same rate as Australia's in an effort to help prevent New Zealand's businesses from jumping across the Tasman. For the first time, businesses investing in research and development (R&D) can now receive a 15% tax credit in the hope of stimulating much needed domestic productivity growth. The cost to the Government for this measure is estimated at NZ \$630 million in deferred revenue over four years. Another new feature will grant individuals a 33% tax rebate for charitable contributions to "qualified donee organizations." This measure is expected to cost NZ\$65 million in deferred tax over four years. There are also new tax exemptions for active income derived from active business activity (e.g., manufacturing, industrial activity) for New Zealand controlled foreign companies to help them globalize at a lower tax and compliance cost (worth NZ\$112.5 million over

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four years) making them more internationally competitive.

¶5. The Government claims these measures will encourage New Zealanders to save rather than spend, which Labour says would decrease inflation and interest rates. But many analysts say the need for NZ Reserve Bank's tighter monetary policy will persist because of high overall consumer demand - especially for housing. Economists also predict that overall economic growth will continue to slow in part by the Kiwi dollar exchange rate, now at a 23-year high and forecast to remain high through March 2009. The GNZ reports growth in GDP at 1.7% for the year as of March 2007 and forecasts growth of 2.6% through March 2008. This is well below the 4% target originally set by the Labour government in 2001.

¶6. (U) On the expenditure side of the Budget, the media has focused primarily on the GNZ's scheme to improve New Zealand's transportation infrastructure. The GNZ will make NZ\$145 million available in capital funding for highway construction and upgrades and NZ\$500 million in funds for the electrification of Auckland's rail network and improvements to Wellington extant network. The funding includes an additional regional fuel tax, subject to voter approval, which in Auckland's case will mean an additional 10 cents per liter on petrol and diesel. This provision is Labour's admittedly perfunctory nod to the Green's demand for a carbon tax on gasoline. For a complete list of both tax and expenditure specifics enumerated in the 2007 Budget see: www.treasury.govt.nz

Cullen yields to political reality

¶7. (U) Dr. Cullen, a reluctant tax cutter at best, decided to signal that personal tax cuts may occur in next year's (the 2008 "pre-election") Budget, a move seen as purely a political decision rather than an economic one. Labour probably hoped it could keep the lid on this proposed 2008 election "sweetener" until after Cullen unveiled the current Budget - his eighth. But Labour's hemorrhaging support in two recent consecutive political opinion polls apparently

startled long-serving Cabinet ministers -particularly Prime Minister Helen Clark, who remembers that National almost won the 2005 elections by promising universal tax cuts. The fact that Cullen has finally been forced to concede (however reluctantly) that a Labour Government will cut personal taxes (later rather than sooner) will be enough to keep his restive colleagues on his side, at least for now.

18. (U) Even if Dr. Cullen finally accedes to tax cuts next year, this measure alone may not guarantee the sort of political insurance the Labour Party needs to return it to power for a fourth term. Labour has hung its hat on distributing benefits only to those in society it deems most in need, especially lower and middle income families with children. The Government also argues that extensive tax cuts will push up inflation and interest rates. The Government's challenge is that the opposition National Party has touched a nerve with voters by claiming that the electorate should be able to make its own spending decisions and all taxpayers deserve lower taxes. Labour knows there is mounting impatience among the electorate for tax relief after years of bulging surpluses. (Note: This year's cash surplus amounts to NZ\$1.7 billion.) More than one analyst has observed that Cullen reneged this year on the very small tax cuts he had promised in last year's budget. The public restiveness is reflected in the latest 3 News-TNS poll taken before the Budget announcement, in which 58 percent of those surveyed said Cullen should be sacked if he did not deliver tax cuts and 66 per cent wanted the top tax rate threshold of 39 per cent (i.e., NZ\$60,000 (approx. US\$45,000) and above which reflects the top 12%) lowered. Cullen has countered by saying the TV3 poll hadn't asked the right question, which would be to ask people if they wanted a substantial tax cut that pushed up mortgage rates or led to cuts to health and education spending.

National Party and Greens critical of Budget

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19. (U) Predictably, in a robust response to Cullen's Budget address to Parliament, National Party leader John Key labeled the 2007 Budget a "cruel hoax". He stated that costs incurred by businesses by paying into employees KiwiSaver schemes will ultimately outweigh and lower any cuts in corporate tax rates. Moreover, Key asserted, middle income New Zealanders will not benefit from the KiwiSaver incentives because their current high debt levels, rising interest rates, and lack of disposable income have made them cash strapped and unable to save. Bosses are also unlikely to offer raises knowing that they will have to kick in to employee KiwiSaver accounts.

110. (U) The Green Party complained that Budget 2007 failed to deliver the necessary environmental benefits to make New Zealand more sustainable and ultimately carbon neutral. Environment Minister David Benson-Pope and Climate Change Minister David Parker proclaimed that the carbon neutral pledge in the Budget was a "bold and exciting" environmental program and noted that more money has been allocated to address sustainability concerns than ever before. National's Key, who himself is trying to improve his own party's green credentials, also argued that the Budget was not green enough. Key has noted that the oft-used Clark slogan of 'carbon neutrality', which Clark established as one of her goals for New Zealand in the unspecified future, was missing from the Budget.

111. (SBU) Comment: Although not expressly stated, it appears that Labour's strategy in the lead-up to next year's election is that it will have begun solidifying its base of support by paying out at least NZ\$1,000 to each wage earner who opens a KiwiSaver account in 2007. They may then reduce the personal tax rates in the 2008 Budget as the second tranche of government largesse to further strengthen voter support but these measures alone may be perceived by Kiwi voters as too

little too late. End comment.

Keegan